the literal definition of a tax-free reorganization, the courts denied the intended benefits of the transactions, stating: ''The purpose of the [reorganization] section is plain enough, men [and women] engaged in enterprises—industrial, commercial, financial, or an other—might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered 'realizing' and profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate 'reorganizations'.'' (69 F.2d at 811).

The economic substance doctrine was applied in the case of *Goldstein* v. *Commissioner* (364 F.2d 734 (2d Cir. 1966)) involving a taxpayer who borrowed to acquire Treasury securities. Under the law then in effect, she was able to deduct a substantial amount of prepaid interest. Notwithstanding that the Code allowed a deduction for the prepaid interest, the Court disallowed the deduction stating: ''this provision [sec. 163(a)] should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose other than to obtain the tax benefit of an interest deduction.''

Likewise in *Shelton* v. *Commissioner* (94 T.C. 738 (1990)), a taxpayer borrowed money to purchase Treasury bills. Under the law at that time, the interest on the borrowing was deductible, but interest on the Treasury bills did not have to be accrued currently. The taxpayer deducted the interest on the borrowing currently and deferred the interest income. The court, as in the *Goldstein* case, disallowed the interest deduction because the transaction lacked economic substance. Similarly, the economic substance doctrine has been applied to disallow losses in cases where taxpayers invested in commodity straddles (*Yosha* v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988)).

Recently, the courts have applied the economic substance doctrine to deny the benefits of an intricate plan principally designed to create losses by investing in a partnership holding debt instruments that were sold for contingent installment notes. Both the Tax Court and the Court of Appeals for the Third Circuit held that the transaction lacked economic substance and thus disallowed the ''artificial loss'' (*ACM Partnership* v. *Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. 2189 (1997)). The Tax Court opinion stated: ''the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in the light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with the commercial practices in the relevant industry . . . A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would at least be commensurate with the transaction costs.''

Courts have likewise denied the tax benefits in cases involving the misuse of seller-financed corporate-owned life insurance (*Winn-Dixie Stores, Inc.* v. *Commissioner*, 113 T.C. No. 21 (1999); *American Electric Power Inc.* v. *United States* (S.D. Ohio, No. C2–99–724, Feb. 20, 2001)) and foreign tax credits (*Compaq Computer Corp.* v. *Commissioner*, 113 T.C. No. 17 (1999). However, see *IES Industries* v. *United States*, 2001 U.S. App. LEXIS 12881 (8th Cir. June 14, 2001) for a contrary decision) in transactions the court determined were lacking economic substance.

Business purpose doctrine

The courts use the business purpose doctrine (in combination with economic substance) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) the transaction lacks economic substance (*Rice's Toyota World*, 752 F.2d 89, 91 (1985)). In essence a transaction will be respected for tax purposes if it has ''economic substance or encouraged by business or regulatory realities, is imbued with tax-independent consideration, and is not shaped solely by tax-avoidance features that have meaningless label attached.'' (*Frank Lyon Co.* v. *Commissioner*, 435 U.S. 561 (1978)).

EXPLANATION OF PROVISION

In general

Under the bill, the economic substance doctrine is made uniform and is enhanced. The bill provides that in applying the economic substance doctrine, a transaction will be treated as having economic substance only if the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the transaction has a substantial nontax purpose which would be reasonably accomplished by the transaction. This aspect of the bill clarifies the judicial application of the economic substance doctrine and would overturn the results in certain court cases, such as the result in *IES Industries* (see above). The bill provides that if a profit potential is relied on to demonstrate that a transaction results in a meaningful change in economic position (and therefore has economic substance), the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. The potential for a profit not in excess of a risk-free rate of return will not satisfy the test. In determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

Under the bill, a taxpayer may rely on factors other than profit potential for a transaction to have a meaningful change in the taxpayer's economic position; the bill merely sets forth a minimum profit potential if that test is relied on to demonstrate a meaningful change in economic position.

In applying the profit test to the lessor of tangible property, depreciation and tax credits (such as the rehabilitation tax credit and the low income housing tax credit) are not to be taken into account in measuring tax benefits. Thus, a traditional leveraged lease is not affected by the bill to the extent it meets the present law standards.

Except as the bill otherwise specifically provides, judicial doctrines disallowing tax benefits for lack of economic substance, business purpose, or similar reasons will continue to apply as under present law.

Transactions with tax-indifferent parties

The bill also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability, for example, by reasons of its method of accounting (such as mark-to-market). Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if it results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

EFFECTIVE DATE

The provision applies to transactions after the date of enactment.

TITLE II—PENALTIES

1. Modifications to accuracy-related penalty (sec. 201)

PRESENT LAW

A 20-percent penalty applies to any portion of an underpayment of income tax required to be shown on a return to the extent that it is attributable to negligence or to a substantial understatement of income tax. For purposes of the penalty, an understatement is considered ''substantial'' if it exceeds the greater of (1) 10 percent of the tax required to be shown on the return, or (2) $5,000 ($10,000 in the case of a C corporation that is not a personal holding company).

The penalty does not apply if there was reasonable cause for the understatement and the taxpayer acted in good faith with respect to the understatement. In addition, except in the case of a tax shelter, the substantial understatement penalty does not apply if there was substantial authority for the tax treatment of an item or if there was adequate disclosure of the item and reasonable basis for the treatment of the item. In the case of a tax shelter of a noncorporate taxpayer, the substantial authority exception applies if the taxpayer reasonably believed that the claimed treatment was more likely than not the proper treatment. For this purpose, a tax shelter means a partnership or other entity, plan or arrangement, if a significant purpose of the entity, plan or arrangement was the avoidance or evasion of Federal income tax.

EXPLANATION OF PROVISION

Enhanced penalty for disallowed noneconomic tax attributes

The bill increases the accuracy-related penalty for underpayments attributable to disallowed noneconomic tax attributes. The rate of the penalty is increased to 40 percent unless the taxpayer discloses to the Secretary of the Treasury or his delegate such information as the Secretary shall prescribe with respect to such transaction. No exceptions (including the reasonable cause exception) to the imposition of the penalty will apply in the case of disallowed noneconomic tax attributes.

The enhanced penalty applies to the extent that the underpayment is attributable to the disallowance of any tax benefit because of a lack of economic substance (as provided by the bill), because the transaction was not respected under the rules added by the bill relating to transactions with tax-indifferent parties, because of a lack of business purpose or because the form of the transaction does not reflect its substance, or because of any similar rule of law disregarding meaningless transactions whose undertaking were not in the furtherance of a legitimate business or economic purpose.

Modifications to substantial understatement penalty

The bill makes several modifications to the substantial understatement penalty. First, the bill treats an understatement as substantial if it exceeds $500,000, regardless of whether it exceeds 10 percent of the taxpayer's total tax liability. Second, the bill treats tax shelters of noncorporate taxpayers the same as the present law treatment of corporate tax shelter; thus the exception from the penalty for substantial authority (under section 6662(b)(2)(B)(i)) will not apply.